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## Section 102: A Persistent Menace to Closely-Held Corporations

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# St. John's Law Review

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## SECTION 102: A PERSISTENT MENACE TO CLOSELY-HELD CORPORATIONS

THOMAS A. BOLAN †

### I. INTRODUCTION

AMONG lawyers, accountants and businessmen, perhaps no other statute in recent years has stirred up as much controversy, confusion and discussion as has Section 102 of the Internal Revenue Code.<sup>1</sup>

In former times when a corporate board of directors determined to retain funds rather than distribute them as divi-

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<sup>1</sup> INT. REV. CODE § 102: "(a) *Imposition of tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

"27½ per centum of the amount of the undistributed section 102 net income not in excess of \$100,000, plus

"38½ per centum of the undistributed section 102 net income in excess of \$100,000.

"(b) *Prima facie evidence.* The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

"(c) *Evidence determinative of purpose.* The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary. . . ." See Legis., *Section 102 and the Forbidden Purpose*, 26 ST. JOHN'S L. REV. 371 (1952).

dends, a challenge to their discretion could emanate only from stockholders of the company. If the stockholders were so inclined, they could take their grievances to court and demand the declaration of a dividend. The answer given by the courts would usually be that, barring bad faith, discretion to declare dividends lies primarily with the directors and will not be interfered with by the courts unless clearly arbitrary or unreasonable and, furthermore, what constitutes a reasonable retention is necessarily best known by the directors.<sup>2</sup> Such a course is still open today to disgruntled stockholders and the attitude of the courts is generally the same.

If there were no considerations other than the foregoing, the management of a corporation would be free to chart the course of its company's progress, being conservative in the preservation of the company's assets if its judgment so warranted, without fear of damaging reprisal in the courts. Unfortunately, no such peace of mind is today available to the directors of many corporations. Section 102 enters the picture to whittle down their discretionary powers and often forces them to declare dividends against the dictates of sound business reasoning.

As worded, Section 102 endeavors to penalize severely any corporation whose "purpose" in withholding dividends is to prevent an imposition of surtax on its stockholders or the stockholders of any other corporation.<sup>3</sup> The penalty consists of additional tax at the rate of 27½% on the first \$100,000 of "undistributed net income" of the year in question and 38½% on the balance. For its own purposes the

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<sup>2</sup> It is "a well-settled principle that whether or not dividends shall be paid, and the amount of the dividend at any time, is primarily to be determined by the directors, and there must be bad faith or a clear abuse of discretion on their part to justify a court of equity in interfering; . . . their judgment in withholding a dividend from the stockholders will be regarded as conclusive, unless they are controlled or limited by statute, charter, by-law, or vote of the stockholders, because it is a matter of internal management with which the courts will not ordinarily interfere." 11 FLETCHER CYC. PRIVATE CORP. 801-806 (Rev. perm. ed. 1932).

<sup>3</sup> Mead Corp. v. Commissioner, 116 F. 2d 187 (3d Cir. 1940), dealing with § 104 of the Revenue Act of 1928, a predecessor of § 102, and holding that where a subsidiary was formed and availed of for the purpose of avoiding surtaxes on the shareholders of the parent corporation, the subsidiary was not subject to the penalty tax, is no longer law by virtue of the provisions of § 102.

statute specifically defines undistributed net income<sup>4</sup> and, very broadly speaking, it is what a corporation would have for dividend purposes if there were no need to provide for the future, less the excess of its long-term capital gains over its short-term capital losses.<sup>5</sup> The statute also states that the fact that any corporation is a *mere* holding or investment corporation shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.<sup>6</sup> Domestic and foreign personal holding companies are now exempt from Section 102, as they are well provided for elsewhere.<sup>7</sup>

It is not the purpose here to go into the legislative history of Section 102, as excellent summations thereof may be found elsewhere.<sup>8</sup> In passing, however, a few of the highlights may be pointed out. Statutes similar to Section 102<sup>9</sup> have been on the books since the Tariff Act of 1913, but at that time the tax was on the stockholder and not the corporation. The early requirement that fraud be present was eliminated in 1918. In 1921 the tax was shifted from the individual to the corporation. At one period, 1924 to 1934, the penalty tax was as high as 50% of the retained earnings.

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<sup>4</sup> INT. REV. CODE § 102(d)(2).

<sup>5</sup> If the stockholders report dividends on the basis of their pro rata share of the undistributed earnings, though none have been declared, such "consent dividends" will be deducted indirectly from the amount of undistributed § 102 net income. See Westfall, *Integrating Federal Income Taxes on Corporations and Their Shareholders*, 27 TAXES 236, 240 (1949), for a simplification of the computation of undistributed § 102 net income, keeping in mind that in 1951 the statute was amended so as to allow a deduction for the excess of long-term capital gains over short-term capital losses.

<sup>6</sup> See *Industrial Bankers Securities Corp. v. Higgins*, 104 F. 2d 177, 181 (2d Cir. 1939), to the effect that the word "mere" in the statute must not be ignored.

<sup>7</sup> INT. REV. CODE § 500 imposes a surtax on domestic personal holding companies (as defined by INT. REV. CODE § 501) in addition to the regular corporation income tax, and INT. REV. CODE § 337 levies a tax on United States shareholders of foreign personal holding companies (as defined by INT. REV. CODE § 331) based on their pro rata share of any undistributed net income. In each case it is of no consequence that the surplus may have been properly accumulated.

<sup>8</sup> Buck & Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 141 (1950) (the first of three published parts, gives a review of the history and background of § 102). See also Turner, *Unreasonable Accumulation of Surplus . . . Section 102*, 26 TAXES 839 (1948).

<sup>9</sup> In dealing with § 102 and its forerunners, the principles laid down by the Board of Tax Appeals and the courts have basically been applicable to both, and, therefore, the citations appearing in this article will not be earmarked by the particular penalty statute to which they refer.

It was in 1934 that personal holding companies were withdrawn from the scope of this tax.<sup>10</sup>

The reason for the statute is obvious. In corporations where small groups own large blocks of stock, the inclination on the part of dominating stockholders might be to withhold dividends in order to escape the personal income tax that would be imposed on them—the heavier the prospective tax, the greater the temptation. Thus, the excess funds could be held by the corporation either until the individual income tax rates were reduced or until such time as allowable personal income tax deductions or a reduction in income from other sources would make a receipt of dividends by the stockholder less productive tax-wise. Or perhaps the aim might be to increase the value of the stock (by not declaring dividends) in order to later liquidate the company or sell the stock at a profit, in either of which event the maximum tax would be just 26%.<sup>11</sup> If no distribution were made before the stockholder's death, the only tax payable would be an inheritance tax based on the market value of the stock at the date of death, a consideration which also might weigh heavily in the minds of controlling stockholders.

Though the statute purports to encompass only situations of this kind, *i.e.*, where the plan of the corporation is to avoid the imposition of surtaxes on its shareholders, its consequences are much more far-reaching in that it also provides that whenever the corporation's accumulation of earnings is beyond its "reasonable needs," the corporation must prove by a "clear preponderance of the evidence" that it was free of any taint of the forbidden purpose.<sup>12</sup> This is a severe burden and one which a corporation quite conceivably could not meet, despite an absence of the condemned intent. In order to escape the penalty of the statute, the taxpayer invariably must show that its accumulation was reasonable, for otherwise any other explanation of the surplus is almost

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<sup>10</sup> Many of the early decisions on the subject under consideration dealt with personal holding companies, which fact, however, does not weaken them as precedents to any considerable degree.

<sup>11</sup> INT. REV. CODE §§ 115(c), 117(c)(2).

<sup>12</sup> This provision was added by the Revenue Act of 1938. Prior thereto an unreasonable accumulation merely created a presumption that the corporation sought to evade taxes.

certain to be unacceptable. In practical effect then, the "liability for tax under Sec. 102 usually hinges on whether the corporation has accumulated its earnings in excess of the reasonable needs of the business."<sup>13</sup>

Thus we come to the same criterion as is usually used in stockholder suits to compel dividends: Was the action of the directors in withholding dividends reasonable? Though the same test is used in both cases, the fact that one involves a stockholder and the other a taxpayer results in two entirely different viewpoints on what is reasonable. Thus in a stockholder suit the court looks with a liberal eye at the action of the directors, but this is not the course followed when the Commissioner of Internal Revenue is the beneficiary of a condemnation of such action. The "present day attitude of the courts"<sup>14</sup> and the Commissioner of Internal Revenue toward corporations is far from sympathetic,<sup>15</sup> and in an effort to extract additional tax old principles are quickly by-passed or discarded.

In the years before and during World War II, Section 102 did "not constitute any great threat to the ordinary corporate taxpayer. Prior to the war period, the section was not aggressively enforced; and during the war period, since income subject to excess profits tax was not subject to Sec. 102 tax, the section had little application."<sup>16</sup> At the present time, however, Section 102 must be given extremely careful consideration before any decision to withhold surplus beyond a normal amount is made.<sup>17</sup> This, of course, is particularly true of corporations under the control of a small group of

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<sup>13</sup> STANLEY & KILCULLEN, *THE FEDERAL INCOME TAX* 129-130 (1948).

<sup>14</sup> As of October 22, 1942, the Board of Tax Appeals became known as "The Tax Court of the United States" and the designation "court" or "courts" in this article will frequently be used not only to indicate official courts but the Board as well.

<sup>15</sup> 14 FLETCHER CYC. PRIVATE CORP. 786 (Replacement vol. 1945), quoting HENDERSON, *INTRODUCTION TO INCOME TAXATION* §106 (1st ed. 1943) as follows: "They [corporations] are artificial creatures of the law, looked at as distinct and apart from their stockholders, and their capacity to pay tribute is as indifferently appraised as if a committee of butchers waited on a corn-fed steer at the stockyards gate."

<sup>16</sup> STANLEY & KILCULLEN, *op. cit. supra* note 13, at 128.

<sup>17</sup> It is also advisable to first estimate the possible impact of § 102 before making a choice of a business organization. KNAPP & WARREN, *FORMS OF BUSINESS ORGANIZATION AND THE FEDERAL TAX LAWS* 24 (Rev. ed. 1951).

stockholders. For the unwary management of such corporations the situation is replete with dangerous possibilities.

## II. INTERPRETATION AND APPLICATION OF SECTION 102

### A. *In General*

On its face, Section 102 seeks to penalize any corporation which has for its purpose the avoidance of surtaxes on its shareholders *through the medium of accumulating earnings or profits*. Despite the clarity of the statutory language, there is evidence in the decisions of efforts to enlarge the stated prohibited purpose so as to include *any use* of a corporation to escape individual income taxes.<sup>18</sup> Any endeavor to thus broaden the scope of Section 102 would certainly seem to be without justification. It has been conceded that "a taxpayer has the legal right to decrease the amount of what would be his taxes or avoid them by means which the law permits."<sup>19</sup> Section 102 merely restricts the use of a corporation for the purpose of accumulating earnings, thus any other method of saving taxes through utilization of a corporation, otherwise valid, should be permissible.<sup>20</sup> Inasmuch as the statute is penal in nature, "it should be strictly construed and should not be extended to cover cases

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<sup>18</sup> "The organization of the plaintiff company [taxpayer] for the purpose of preventing the imposition of the surtax upon its stockholders was itself an inhibited act, and the very purpose of Congress was to prevent the evasion of income tax by stockholders." *Beim Co. v. Landy*, 113 F. 2d 897, 900 (8th Cir. 1940). "The purpose of section 104 [a predecessor of 102] clearly was to penalize the intentional avoidance of surtaxes upon individuals by the intervention of corporations." *Corporate Investment Co.*, 40 B. T. A. 1156, 1177 (1939) (dissenting opinion).

<sup>19</sup> *Helvering v. Johnson*, 104 F. 2d 140, 143 (8th Cir.), *aff'd mem.*, 308 U. S. 523 (1939).

<sup>20</sup> *Corporate Investment Co.*, 40 B. T. A. 1156 (1939), wherein it was held that § 104, a forerunner of § 102, was not applicable, even though an individual stockholder had deliberately used the taxpayer corporation to save taxes. However, on a similar set of facts in *Beim Co. v. Landy*, 113 F. 2d 897 (8th Cir. 1940), § 104 was held to apply. The following language of the dissenting opinion at 902 is quite persuasive: "Section 104 was directed at corporations which were designed or used to prevent, through the accumulation of distributable profits, the imposition of surtaxes upon their shareholders, and not at corporations designed or used to prevent, in some other way, the imposition of such surtaxes. The *Beim Company* [the taxpayer involved] was formed to prevent the imposition of surtaxes, but not in the particular way which would make it liable to the . . . penalty tax."

which do not fall within its letter.”<sup>21</sup> The provisions of 102 are definite and specific and they clearly limit its application to improper accumulation of earnings.

### B. *The Prohibited Purpose*

Although on the one hand, the courts have not been in agreement as to whether or not the 102 penalty should be applied automatically when a corporation has been used to avoid surtaxes, on the other hand, they have uniformly held that the existence of an intent to effectuate that end is a prime and absolute requisite. Tax-saving through accumulation of profits may be evidence of the prohibited purpose,<sup>22</sup> but the “touchstone of liability under Sec. 102 is the purpose behind the accumulation of the income and not the consequence of the accumulation.”<sup>23</sup> Thus it has been held that a huge saving of individual surtaxes through the accumulation of corporate earnings is not sufficient in and of itself to warrant the imposition of 102 without proof of the forbidden purpose.<sup>24</sup> It has been decided, however, that even if the disapproved purpose was not executed, if the intent was present, the penalty tax is applicable, the court reasoning that the “legislative aim no doubt was to discourage the attempt thus to misuse a corporation as well as to neutralize success.”<sup>25</sup>

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<sup>21</sup> United Business Corp. of America, 19 B. T. A. 809, 826 (1930), *aff'd*, 62 F. 2d 754 (2d Cir.), *cert. denied*, 290 U. S. 635 (1933).

<sup>22</sup> Cecil B. DeMille, 31 B. T. A. 1161 (1935), *aff'd sub nom.* Commissioner v. Cecil B. DeMille Productions, Inc., 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937); Mellbank Corp., 38 B. T. A. 1108 (1938). In R. L. Blaffer & Co., 37 B. T. A. 851 (1938), *aff'd*, 103 F. 2d 487 (5th Cir.), *cert. denied*, 308 U. S. 576 (1939), the Board stated: “In the absence of the condemned purpose, the effect alone is no foundation for the tax. This is not to say that the effect is of no significance, for it may, and perhaps often does, indicate the probability of a purpose to induce it. In ordinary life it is not unreasonable to infer that the effect of a voluntary act is among the purposes of the actor.” *Id.* at 856.

<sup>23</sup> World Pub. Co. v. United States, 72 F. Supp. 886, 889 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949); see also KOMA, Inc. v. Commissioner, 189 F. 2d 390, 396 (10th Cir. 1951) (It is not “decisive whether the decisions to accumulate the income and the failure to distribute profits were wisely made.”).

<sup>24</sup> Corporate Investment Co., 40 B. T. A. 1156 (1939) (taxpayer mistakenly thought all earnings had been distributed); Cecil B. DeMille, *supra* note 22.

<sup>25</sup> A. D. Saenger, Inc. v. Commissioner, 84 F. 2d 23, 24 (5th Cir.), *cert. denied*, 299 U. S. 577 (1936).



The mere fact that in accumulating profits there are present other motives in addition to the one of saving individual surtaxes does not take the corporation outside the pale of Section 102; there must be a complete absence of the condemned purpose.<sup>26</sup> Thus, it is not necessary that a design to escape taxes be the predominant purpose.<sup>27</sup> Also, the fact that a corporate practice was originally adopted with no tax-saving motive in mind is not decisive, inasmuch as its continuance might have been induced, in whole or in part, by a desire to minimize taxes.<sup>28</sup>

Nearly all of the decisions against the taxpayer have been on the ground that the corporation was "availed of" for the interdicted purpose and very few have held that the taxpayer was "formed" for such purpose.<sup>29</sup> Wherever the charge has been that the corporation was both formed and availed of for the purpose of avoiding taxes, the courts have usually given the bulk of their consideration to the "availed of" charge, an adverse ruling on either charge being sufficient to penalize fully the taxpayer. The following claimed incentives in *forming* corporations have been approved by the courts: to unify various companies owned by the stockholders, to eliminate double taxation, to escape creditors,<sup>30</sup>

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<sup>26</sup> R. L. Blaffer & Co., *supra* note 22. Where there is present a tax-saving purpose, any other purposes would be "incidental" and would appear "as excuses, or afterthoughts, rather than evidence of an absence of the purpose described in the statute." Trico Products Corp., 46 B. T. A. 346, 374 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>27</sup> Trico Products Corp. v. Commissioner, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>28</sup> See *Helvering v. Chicago Stock Yards Co.*, 318 U. S. 693, 699 (1943).

<sup>29</sup> Where there has been a finding that the taxpayer was *formed* for the condemned purpose, an investment or holding corporation has usually been involved, as in *Beim Co. v. Landy*, 113 F. 2d 897 (8th Cir. 1940), and *Reynard Corp.*, 37 B. T. A. 552 (1938). As a matter of fact, a statistical analysis of all § 102 cases reveals that regardless of whether it was the "formed" or "availed of" provision that was considered, investment and holding companies have fared much worse than regular operating companies. Buck & Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 323, Appendix (1950) (the second of three published parts). It has been held that holding companies are not limited by definition to those which are passive, but include those which deal actively with their holdings, and that a company which deals in speculations may nevertheless be deemed an investment company. *Rands, Inc.*, 34 B. T. A. 1094 (1936), *appeal dismissed*, 101 F. 2d 1018 (6th Cir. 1939).

<sup>30</sup> *Delaware Terminal Corp.*, 40 B. T. A. 1180 (1939). This case also held that where a corporation has more than one stockholder it can not be compelled to rely, in an emergency, on those stockholders to repay any dividends

to create and support a market for certain stock,<sup>31</sup> to control the principal stockholder's spending and to provide for the possibility of selling and distributing his creations.<sup>32</sup>

It is frequently alleged that a corporation was formed or availed of to facilitate the handling of a stockholder's financial affairs upon his death or to avoid expected complications resulting therefrom. This sort of claim has almost never brought success to a taxpayer.<sup>33</sup> However, where the anticipated contingencies are to flow from the death of some one other than the controlling shareholder, the courts have been more lenient. Thus, where it was asserted that a partnership was converted into a corporation because one of the partners feared that upon the death of his copartner the settlement of the latter's estate would require the withdrawal of assets from the partnership, the court sustained the taxpayer's contention.<sup>34</sup> Similarly, where a stockholder's interest in a certain contract would probably have been placed in jeopardy by the death of any of the other parties interested in said contract and a corporation was formed to eliminate this risk, no penalty tax was imposed.<sup>35</sup>

Claims that the purpose of a corporation's organization was to provide a stockholder or a relative with an occupation have usually not been sustained.<sup>36</sup> Evidence that a corporation was advised by lawyers or accountants that it should not pay dividends has negated the existence of an intent to avoid taxes.<sup>37</sup>

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received by them, thus distinguishing *Helvering v. National Grocery Co.*, 304 U. S. 282, 294 (1938), wherein the Court stated that the taxpayer should have paid out more of its surplus than it did since its sole stockholder would have put the money back into the corporation if the need would have arisen for so doing.

<sup>31</sup> See *Trico Securities Corp.*, 41 B. T. A. 306 (1940).

<sup>32</sup> See *Fisher & Fisher, Inc.*, 32 B. T. A. 211 (1935), *aff'd mem.*, 84 F. 2d 996 (2d Cir. 1936).

<sup>33</sup> See *R. L. Blaffer & Co.*, 37 B. T. A. 851 (1938), *aff'd*, 103 F. 2d 487 (5th Cir.), *cert. denied*, 308 U. S. 576 (1939); *Reynard Corp.*, 37 B. T. A. 552 (1938); *Nipoch Corp.*, 36 B. T. A. 662 (1937); *R. & L., Inc.*, 33 B. T. A. 857 (1935), *aff'd*, 84 F. 2d 721 (5th Cir.), *cert. denied*, 299 U. S. 588 (1936).

<sup>34</sup> See *C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511 (1938).

<sup>35</sup> See *Sauk Investment Co.*, 34 B. T. A. 732 (1936).

<sup>36</sup> See *R. L. Blaffer & Co.*, *supra* note 33; *Rands, Inc.*, 34 B. T. A. 1094 (1936), *appeal dismissed*, 101 F. 2d 1018 (6th Cir. 1939).

<sup>37</sup> *Cf. William C. Atwater & Co.*, 10 T. C. 218 (1948).

Of considerable weight, but by no means conclusive, is the amount of personal income tax saved by reason of non-payment of dividends by the stockholders of the corporation sought to be penalized.<sup>38</sup> In the leading case of *Trico Products Corp.*,<sup>39</sup> the Board of Tax Appeals held, in effect, that so much was saved on personal taxes that there must have been a purpose on the part of the corporation to avoid taxes. However, in another case where there was little or no tax saved by the stockholders, the penalty tax was nevertheless levied, the court holding that the weight to be given this fact was within the discretion of the Board.<sup>40</sup>

### C. Reasonable Needs

It is obvious that if the Commissioner had the naked burden of proving the taxpayer's intent to avert taxes, he would be faced with a difficult task. However, the party with the troublesome task is the taxpayer, not the Commissioner, because, as was previously stated, the statute provides that where a corporation has an accumulation "beyond the reasonable needs of the business" it must prove by "the clear preponderance of the evidence" an absence of the prescribed purpose. It should be remembered that the taxpayer must also contend with the presumption that any determination of the Commissioner is correct.<sup>41</sup> While it is theoretically possible for a corporation to show that though its accumulation was excessive, it did not have any wrongful intent,<sup>42</sup> almost all of the decided cases have turned on the

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<sup>38</sup> See *Charleston Lumber Co. v. United States*, 20 F. Supp. 83 (S. D. W. Va.), *appeal dismissed*, 93 F. 2d 1018 (4th Cir. 1937); *R. C. Reynolds, Inc.*, 44 B. T. A. 356 (1941); *Corporate Investment Co.*, 40 B. T. A. 1156 (1939). In each of these cases there was little or no saving in personal income taxes and in each case the corporation was held to be exempt from the penalty tax.

<sup>39</sup> 46 B. T. A. 346, 380 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>40</sup> *Wilson Bros. & Co. v. Commissioner*, 124 F. 2d 606 (9th Cir. 1941).

<sup>41</sup> See *Olin Corp.*, 42 B. T. A. 1203 (1940), *aff'd*, 128 F. 2d 185 (7th Cir. 1942). In criticizing the use of this presumption, one author states that it "is applied haphazardly and unevenly and can be and is a mask for the intuition of judges and administrators when it is not actually a trap for an unlucky or unwary taxpayer." Marcossin, *The Burden of Proof in Tax Cases*, 29 TAXES 221, 240 (1951).

<sup>42</sup> "Even if it should clearly appear that the accumulations were in excess

question of whether the accumulation was reasonably needed by the corporation. Once the corporation proves its accumulation was reasonable, the Commissioner is almost sure to lose,<sup>43</sup> although here again in theory he may still prove the condemned purpose;<sup>44</sup> if the corporation cannot establish a reasonable accumulation then it is almost certain to be the loser.

When, prior to the Revenue Act of 1938, the existence of an unreasonable accumulation merely created a presumption of a purpose to avoid taxes, Judge Learned Hand commented on this presumption as follows:

A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand.<sup>45</sup>

With the revision of the statute, the taxpayer is no longer faced with a mere presumption, but must engage in a do-or-die effort to prove absence of an unlawful intent. Instead of simply "showing his hand" he must strenuously seek to persuade the court that his "hand" is a good one. Generally, in order to escape the penalty tax, the taxpayer must present proof of a purpose to provide for business needs "so satisfy-

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of the reasonable needs of the corporate business, section 220 [now 102] would not apply unless it further appears that the accumulations were intentionally permitted for the express purpose of enabling the stockholders to evade the surtax." *R. C. Tway Coal Sales Co. v. United States*, 3 F. Supp. 668, 671 (W. D. Ky. 1933), *aff'd*, 75 F. 2d 336 (6th Cir. 1935); *see* *World Pub. Co. v. United States*, 169 F. 2d 186, 187 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

<sup>43</sup> It has been stated that the "fact that the surplus is not unreasonably large in respect to the needs of the corporation's business is repugnant to the existence of such purpose [to avoid personal surtaxes], and, while not conclusive, must be accepted as substantial evidence in denial of proofs or inferences that it exists." *United States v. R. C. Tway Coal Sales Co.*, 75 F. 2d 336, 337 (6th Cir. 1935).

<sup>44</sup> The "tax may be imposed, even though the accumulation is not unreasonably large. . . ." *World Pub. Co. v. United States*, *supra* note 42, at 187. In *United Business Corp. of America v. Commissioner*, 62 F. 2d 754, 755 (2d Cir.), *cert. denied*, 290 U. S. 635 (1933), the following observation was made: "Ordinarily it will indeed be difficult to prove the forbidden purpose, unless the accumulations are too large for the fair needs of the business. But it may not be impossible to do so. . . ."

<sup>45</sup> *United Business Corp. of America v. Commissioner*, *supra* note 44, at 755.

ing and persuasive that it is unnecessary to look further for a motive for the action under criticism." <sup>46</sup>

Quite naturally it is impossible to outline any precise set of rules that could be utilized in determining what constitutes the reasonable needs of a business. Each case must necessarily turn on its own facts.<sup>47</sup> "What would be reasonable in one situation or for one business might be clearly unreasonable in another."<sup>48</sup> "Prominent factors in one case may become minor in another."<sup>49</sup> However, some of the considerations that have been taken into account by the courts in ascertaining the reasonableness of an accumulation are as follows: the nature and volume of the corporate business, the keenness of competition, principles of good business management, the conditions of the times, the possibilities of harmful legislation affecting the industry, the rate of current earnings;<sup>50</sup> the amount of "quick assets" on hand compared to the amount necessary to operate the business;<sup>51</sup> whether minutes of meetings were kept;<sup>52</sup> and whether or not previous policies were conservative.<sup>53</sup> The decisions themselves have frequently been inconsistent when dealing with almost identical factual situations. Nevertheless, in the hope that some semblance of pattern may be gleaned therefrom, there follows a brief outline of many of the factual presentations

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<sup>46</sup> Trico Products Corp., 46 B. T. A. 346, 374 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>47</sup> The answer to what are reasonable or unreasonable needs of a business "is rarely easy to find." Dill Mfg. Co., 39 B. T. A. 1023, 1031 (1939).

<sup>48</sup> See William C. deMille Productions, Inc., 30 B. T. A. 826, 830 (1934), *appeal and cross appeal dismissed*, 80 F. 2d 1010 (9th Cir. 1936).

<sup>49</sup> Universal Steel Co., 5 T. C. 627, 637 (1945).

<sup>50</sup> See World Pub. Co. v. United States, 72 F. Supp. 886, 894-895 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

<sup>51</sup> See United Block Co. v. Helvering, 123 F. 2d 704 (2d Cir. 1941), *cert. denied*, 315 U. S. 812 (1942) (Cash, notes receivable, investments, and possibly accounts receivable were included within the meaning of "quick assets").

<sup>52</sup> See KOMA, Inc. v. Commissioner, 189 F. 2d 390 (10th Cir. 1951); W. H. Gunlocke Chair Co. v. Commissioner, 145 F. 2d 791 (2d Cir. 1944); Cecil B. DeMille, 31 B. T. A. 1161 (1935), *aff'd sub nom.* Commissioner v. Cecil B. DeMille Productions, Inc., 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937) (minutes corroborated claimed purpose).

<sup>53</sup> See Dill Mfg. Co., 39 B. T. A. 1023 (1939). But see W. H. Gunlocke Chair Co. v. Commissioner, *supra* note 52, wherein the taxpayer had a certain surplus in 1930, which decreased steadily from 1930 to 1933 because of the depression, but was gained back by the end of the taxable year 1939 and nevertheless held to have been unreasonably accumulated.

that have been submitted to the courts and their decisions in respect thereto.

In general, where there is a clear-cut need to purchase new equipment, reserves for such purpose have been sanctioned by the courts.<sup>54</sup> Also, fluctuating economic conditions, particularly those brought about by wars or depressions, have frequently been recognized by the courts as a valid reason for accumulating profits.<sup>55</sup> However, in *Gibbs & Cox, Inc. v. Commissioner*,<sup>56</sup> the contention that reserves were needed for an inevitable conversion from wartime to peacetime conditions was not accepted by the court. Likewise, the court found for the Commissioner in the face of an assertion that retention of surplus had been necessitated by shortages in materials and other uncertainties caused by war.<sup>57</sup>

A persistently approved reason for the accumulation of profits is a desire on the part of corporations to become independent, either production-wise or financial-wise.<sup>58</sup> However, where a corporation has as its aim the improvement of its financial position through assistance to allied companies or other organizations in which it has an interest, the courts have not been prone to side with the taxpayer. Thus, in *Helvering v. Chicago Stock Yards Co.*,<sup>59</sup> where the taxpayer's claim was that it had accumulated profits in order

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<sup>54</sup> See *Universal Steel Co.*, 5 T. C. 627 (1945).

<sup>55</sup> See *Industrial Bankers Securities Corp. v. Higgins*, 104 F. 2d 177 (2d Cir. 1939) (business bad because of depression); *Charleston Lumber Co. v. United States*, 20 F. Supp. 83 (S. D. W. Va.), *appeal dismissed*, 93 F. 2d 1018 (4th Cir. 1937) (lumber market poor); *J. L. Goodman Furniture Co.*, 11 T. C. 530 (1948) (expected post-war furniture boom); *Lion Clothing Co.*, 8 T. C. 1181 (1947) (fear of depression); *Universal Steel Co.*, *supra* note 54 (period of changing government controls); *General Smelting Co.*, 4 T. C. 313 (1944) (expected metal business expansion due to war); *Delaware Terminal Corp.*, 40 B. T. A. 1180 (1939) (depression hazards); *Mellbank Corp.*, 38 B. T. A. 1108 (1938) (bank depression).

<sup>56</sup> 147 F. 2d 60 (2d Cir. 1945).

<sup>57</sup> *World Pub. Co. v. United States*, 72 F. Supp. 886 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949) (surplus far in excess of previously-anticipated needs).

<sup>58</sup> See *Industrial Bankers Securities Corp. v. Higgins*, *supra* note 55; *Lion Clothing Co.*, *supra* note 55; *Cecil B. DeMille*, 31 B. T. A. 1161 (1935), *aff'd sub nom. Commissioner v. Cecil B. DeMille Productions, Inc.*, 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937). However, in *Gibbs & Cox, Inc. v. Commissioner*, *supra* note 56, the court rejected the claim that the taxpayer desired to become independent of financing supplied by outside sources.

<sup>59</sup> 318 U. S. 693 (1943).

to first pay off its holding company's debts and then to gain control over and liquidate it, the Commissioner's 102 assessment was upheld by the Supreme Court of the United States. The result was the same where a corporation maintained that it needed funds to "finance" another company in order that it would not lose its investment in it, the Board holding that the business of the other company "was not the business of the taxpayer."<sup>60</sup> Where a taxpayer and another newspaper had merged their operating facilities and each agreed to pay one-half of the purchase price of a badly needed new press, but where it was apparent that the taxpayer would have to advance the full amount at the outset (and in fact ultimately did), the court, nevertheless, held that a reserve to cover the other newspaper's one-half was not part of taxpayer's reasonable business needs.<sup>61</sup> However, in *Mellbank Corp.*,<sup>62</sup> a retention of surplus to safeguard the taxpayer's investments in the stock of its member banks was not disapproved by the Board.

The following miscellaneous situations have been accepted as valid excuses for the non-payment of dividends: the contingency that taxpayer's only customer might be lost and the prospect of moving its plant or opening a new one in another part of the country;<sup>63</sup> taxpayer's business was very risky;<sup>64</sup> the capital retained was less than was necessary for three months' operation;<sup>65</sup> an existing agreement with a bank not to declare dividends until certain loans were repaid and the necessity of having to borrow money for the payment of any dividends;<sup>66</sup> an expected increase in business;<sup>67</sup> a plan to establish branch stores;<sup>68</sup> a desire to purchase certain merchandising concessions and the necessity of

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<sup>60</sup> *Keck Investment Co.*, 29 B. T. A. 143, 149 (1933), *aff'd*, 77 F. 2d 244 (9th Cir.), *cert. denied*, 296 U. S. 633 (1935).

<sup>61</sup> *World Pub. Co. v. United States*, *supra* note 57.

<sup>62</sup> 38 B. T. A. 1108 (1938).

<sup>63</sup> See *L. R. Teeple Co.*, 47 B. T. A. 270 (1942). But see *Eastern Ry. & Lumber Co.*, 12 T. C. 869 (1949).

<sup>64</sup> See *Seaboard Security Co.*, 38 B. T. A. 560 (1938); *Cecil B. DeMille*, 31 B. T. A. 1161 (1935), *aff'd sub nom. Commissioner v. Cecil B. DeMille Productions, Inc.*, 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937).

<sup>65</sup> See *Universal Steel Co.*, 5 T. C. 627 (1945).

<sup>66</sup> See *Trico Securities Corp.*, 41 B. T. A. 306 (1940).

<sup>67</sup> See *C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511 (1938).

<sup>68</sup> See *J. L. Goodman Furniture Co.*, 11 T. C. 530 (1948).

increasing taxpayer's inventory;<sup>69</sup> a fear that an important contract would not be completed or would not be renewed;<sup>70</sup> and the pendency of adverse legislation.<sup>71</sup>

The following stated intents in withholding dividends have been unsuccessfully urged by corporations seeking to be exempted from the 102 penalty: to meet the possibility that certain financial aid would be discontinued and the risk of liability arising from the negligence of taxpayer's employees;<sup>72</sup> to erect a theater in the event a certain lease would not be renewed;<sup>73</sup> to make up for the loss of business that would ensue upon the expiration of an important patent and to protect the financial interests of certain stockholders;<sup>74</sup> to prosecute or defend against possible patent infringement suits and to raise the book value of the corporate stock to approximate its market value in order to protect the public;<sup>75</sup> to develop an invention;<sup>76</sup> and to provide against the recurrence of boycotts.<sup>77</sup>

#### D. *Undefined or Future Needs*

Adding to the taxpayer's already stiff task of defending against charges of Section 102 violation is the principle laid down in some of the decisions that the excess capital must not only be for a specific and definite need,<sup>78</sup> but such need must be "immediate or reasonably immediate."<sup>79</sup> The need

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<sup>69</sup> See *Lion Clothing Co.*, 8 T. C. 1181 (1947).

<sup>70</sup> See *Fisher & Fisher, Inc.*, 32 B. T. A. 211 (1935), *aff'd mem.*, 84 F. 2d 996 (2d Cir. 1936). But see *Reynard Corp.*, 37 B. T. A. 552 (1938).

<sup>71</sup> See *Seaboard Security Co.*, 38 B. T. A. 560 (1938). But see *Albert L. Allen Co.*, 3 CCH 1944 TC MEM. DEC. 1246 (1944) (adverse legislation in rumor stage).

<sup>72</sup> See *Gibbs & Cox, Inc. v. Commissioner*, 147 F. 2d 60 (2d Cir. 1945).

<sup>73</sup> See *Twin City Theatres*, P-H 1952 TC MEM. DEC. ¶ 52,133 (1952).

<sup>74</sup> See *Trico Products Corp.*, 46 B. T. A. 346 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>75</sup> See *Trico Products Corp. v. McGowan*, 67 F. Supp. 311 (W. D. N. Y. 1946), *aff'd*, 169 F. 2d 343 (2d Cir.), *cert. denied*, 335 U. S. 899 (1948).

<sup>76</sup> See *Semagraph Co. v. Commissioner*, 152 F. 2d 62 (4th Cir. 1945).

<sup>77</sup> See *Wilkerson Daily Corp., Ltd.*, 42 B. T. A. 1266 (1940), *aff'd*, 125 F. 2d 998 (9th Cir. 1942).

<sup>78</sup> See *Trico Products Corp. v. McGowan*, *supra* note 75, at 318 (by implication).

<sup>79</sup> *Eastern Ry. & Lumber Co.*, 12 T. C. 869, 875 (1949); *accord*, *World Pub. Co. v. United States*, 72 F. Supp. 886 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).



must be "associated with business in hand."<sup>80</sup> In *Sema-graph Co.*,<sup>81</sup> the court indicated that there must be "substantial proof of a specific plan, objective or contingency which, in the exercise of good business judgment, demanded the accumulation of the earnings and profits in a reasonable and reasonably definite amount."<sup>82</sup> In *World Publishing Company v. United States*,<sup>83</sup> the taxpayer in 1942 and 1943 (the taxable years in question) badly needed certain equipment and a building plant but was unable to purchase the same because World War II was in progress at the time. In holding that a reserve for the stated needs was unreasonable, the court laid stress on the fact that there was no possibility of being able to buy the equipment or the plant until the war ended and that the "company's expansion program lay in the indefinite post-war future."<sup>84</sup> This and similar decisions certainly seem unjust to the taxpayer. Common sense decries against the implication of these rulings that future needs, though known today, must be taken care of by future earnings. Furthermore, is a corporation to be allowed nothing for "a rainy day"? Granted that where a substantial surplus exists a mere claim that the same is needed for contingencies that are unexpected and unforeseeable should not result in getting the taxpayer off the Commissioner's hook; nevertheless, the doctrine that the corporate need must be specific, definite and immediate is beyond a doubt arbitrary and wholly unfair to the taxpayer and certainly militates against the use of sound business principles.

#### E. Loans to Stockholders

Another factor which has played a prominent part in the downfall of the taxpayer in Section 102 cases is loans

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<sup>80</sup> *McCutchin Drilling Co. v. Commissioner*, 143 F. 2d 480, 482 (5th Cir. 1944).

<sup>81</sup> 3 CCH 1944 TC MEM. DEC. 812 (1944), *aff'd*, 152 F. 2d 62 (4th Cir. 1945).

<sup>82</sup> *Id.* at 815.

<sup>83</sup> *Supra* note 79. This case has been referred to as "probably the most extreme case against the taxpayer on the books." Cary, *Section 102 May Not Be the Menace Some Tax Men Consider It To Be*, 89 J. ACCOUNTANCY 219, 221 (1950).

<sup>84</sup> *World Pub. Co. v. United States*, 72 F. Supp. 886, 893 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

made by the corporation to its stockholders.<sup>85</sup> In *United Business Corporation of America v. Commissioner*,<sup>86</sup> the court held that such loans are "incompatible with a purpose to strengthen the financial position of the petitioner [taxpayer], but entirely accord with a desire to get the equivalent of his [a stockholder's] dividends under another guise."<sup>87</sup> Similarly, in *KOMA, Inc. v. Commissioner*,<sup>88</sup> the court held that where a corporation made loans to its stockholders at normal rates but did not require the payment of interest, this "in substance gave the stockholders the benefit of a declared dividend without the attendant tax burden resulting from a dividend payment."<sup>89</sup> However, it is very important to note that where the shareholders have paid interest and the loans have not weakened the corporate financial picture, the loans have usually been approved by the courts.<sup>90</sup> Nevertheless, where the borrower would not have been able to get a loan from a prudent lender, the corporation was penalized despite the borrower's willingness to pay higher interest than banks would pay.<sup>91</sup> Even the fact that the loans are secured may not be enough to swing the case in favor of the taxpayer.<sup>92</sup>

In one case it was held that though loans to stockholders were not legitimate business purposes, insurance to recoup on such loans was permissible.<sup>93</sup> Loans to individuals who are not the majority stockholders have generally been sanctioned.<sup>94</sup> Where loans by the stockholders exceeded in amount loans to the stockholders, the corporation was not taxed under Section 102.<sup>95</sup> Decisions dealing with non-

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<sup>85</sup> See *William C. deMille Productions, Inc.*, 30 B. T. A. 826 (1934), *appeal and cross appeal dismissed*, 80 F. 2d 1010 (9th Cir. 1936) (good illustration of how decisive such loans frequently are).

<sup>86</sup> 62 F. 2d 754 (2d Cir.), *cert. denied*, 290 U. S. 635 (1933).

<sup>87</sup> *Id.* at 755.

<sup>88</sup> 189 F. 2d 390 (10th Cir. 1951).

<sup>89</sup> *Id.* at 396.

<sup>90</sup> See *Corporate Investment Co.*, 40 B. T. A. 1156 (1939).

<sup>91</sup> See *Wilkerson Daily Corp.*, 42 B. T. A. 1266 (1940), *aff'd*, 125 F. 2d 998 (9th Cir. 1942).

<sup>92</sup> See *United Business Corp. of America*, 19 B. T. A. 809 (1930), *aff'd*, 62 F. 2d 754 (2d Cir.), *cert. denied*, 290 U. S. 635 (1933).

<sup>93</sup> See *General Smelting Co.*, 4 T. C. 313 (1944).

<sup>94</sup> See *R. C. Reynolds, Inc.*, 44 B. T. A. 356 (1941).

<sup>95</sup> See *C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511 (1938).

interest bearing loans to executors of deceased stockholders have not produced any particular rule for that type of case.<sup>96</sup>

There have been several decisions departing from the general rule with rather unconvincing explanations being given therefor. For example, where the chief stockholder borrowed large sums, which he did not repay, the penalty tax was not imposed because said stockholder had no responsibility in the management of the corporation.<sup>97</sup> Also, where the corporation obtained bank loans and delivered the money to stockholders, who did not make repayment, no tax was levied, apparently on the ground that the corporation was a mere front for the stockholders in obtaining the bank loans.<sup>98</sup>

#### F. *Reinvestment of Surplus*

The manner in which surplus funds have been reinvested poses a ticklish question—one with which the courts have had a great deal of trouble. It has been asserted that the statute does "not contemplate that a business should remain static"<sup>99</sup> and that "it must be assumed that any business shall have the right to grow."<sup>100</sup> It is obvious, however, that if any and all reinvestment of earnings were to be upheld, then Section 102 would soon be a useless piece of legislation. The question is where the line of demarcation should be drawn. Where investment or holding companies are involved<sup>101</sup> or where the reinvestment (particularly when in the contemplation stage) is in a field unrelated to the busi-

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<sup>96</sup> See *Irvington Investments Co.*, 32 B. T. A. 1165 (1935) (taxpayer lent money to executors to pay inheritance taxes and no penalty was imposed); *Whitney Chain & Mfg. Co.*, 3 T. C. 1109 (1944), *aff'd*, 149 F. 2d 936 (2d Cir. 1945) (taxpayer lent money to stockholder's estate for purpose of paying taxes and other claims and penalty tax was imposed on the ground that among other plans a dividend could have been declared conditioned upon its return to the taxpayer in liquidation of the loan).

<sup>97</sup> *Fisher & Fisher, Inc.*, 32 B. T. A. 211 (1935), *aff'd mem.*, 84 F. 2d 996 (2d Cir. 1936).

<sup>98</sup> See *R. C. Tway Coal Sales Co. v. United States*, 75 F. 2d 336 (6th Cir. 1935).

<sup>99</sup> *William C. deMille Productions, Inc.*, 30 B. T. A. 826, 830 (1934), *appeal and cross appeal dismissed*, 80 F. 2d 1010 (9th Cir. 1936).

<sup>100</sup> *Ibid.*

<sup>101</sup> See *Beim Co. v. Landy*, 113 F. 2d 897 (8th Cir. 1940); *Almours Securities, Inc. v. Commissioner*, 91 F. 2d 427 (5th Cir. 1937), *cert. denied*, 302 U. S. 765 (1938).

ness of the corporation, the courts have generally found against the taxpayer.<sup>102</sup> Carried to its ultimate, this "would mean that funds could not be retained to branch out into any venture afield from the existing enterprise of a taxpayer,"<sup>103</sup> a consequence that would be exceedingly undesirable. Moreover, in determining what constitutes a related field, the courts have been rather harsh on the taxpayer. For example, in *World Publishing Company v. United States*, *supra*, the court held that it was unreasonable for a newspaper to acquire a surplus for the purpose of purchasing a radio station, disregarding the fact that it has been a frequent and customary practice for newspapers to make such acquisitions. However, where investments in a foreign field were made in order to promote business for the company, such investments were upheld.<sup>104</sup> Investments by a loan company in securities and real estate in order to bolster its credit rating were also sustained.<sup>105</sup> Furthermore, where an accumulation of earnings is necessary, though temporarily the funds cannot be used in the business, investments in unrelated fields will be sanctioned, provided said investments can be readily liquidated for use in the business. Thus, in *C. H. Spitzner & Son, Inc.*,<sup>106</sup> the Board maintained that "[c]ommon sense required that the inactive funds [of a tobacco company] be employed as profitably as they might be. So it is not surprising that they were invested in income producing securities."<sup>107</sup>

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<sup>102</sup> See *J. M. Perry & Co. v. Commissioner*, 120 F. 2d 123 (9th Cir. 1941) (investments by storage company in mining stock and real estate); *Southland Industries, Inc.*, 5 CCH 1946 TC MEM. DEC. 950 (1946) (radio broadcasting company desired to enter into merchandising field). But see *Fisher & Fisher, Inc.*, 32 B. T. A. 211 (1935), *aff'd mem.*, 84 F. 2d 996 (2d Cir. 1936) (corporation formed for purpose of promoting chief stockholder's cartoons invested heavily in said stockholder's real estate and racing and breeding stables).

<sup>103</sup> *Holzman, What's New in 102?*, 25 TAXES 101, 107 (1947).

<sup>104</sup> *Charleston Lumber Co. v. United States*, 20 F. Supp. 83 (S. D. W. Va.), *appeal dismissed*, 93 F. 2d 1018 (4th Cir. 1937).

<sup>105</sup> See *Seaboard Security Co.*, 38 B. T. A. 560 (1938).

<sup>106</sup> 37 B. T. A. 511 (1938).

<sup>107</sup> *Id.* at 521; *accord*, *Cecil B. DeMille*, 31 B. T. A. 1161 (1935), *aff'd sub nom. Commissioner v. Cecil B. DeMille Productions, Inc.*, 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937) (motion picture company invested in securities, real estate and numerous varied enterprises, many of which had little or no relation to the motion picture business).

G. *Effect of Shrinkage of Assets*

A frequently claimed justification for withholding dividends is shrinkage in the taxpayer's paid-in capital by reason of depreciation in value of its capital assets. Such claims have not been received very sympathetically by the courts, particularly where investment or holding companies have been involved.<sup>108</sup> Therefore, where a company is earning profits it must, under Section 102 rulings, pay out dividends even though its assets may be dwindling in value at a greater rate than profits are being realized. Here again the rulings of the court seem to collide with and penalize the exercise of sound business judgment. In referring to a taxpayer's shrunken assets, the Board in *C. H. Spitzner & Son, Inc.*, *supra*, stated that they "would be useful to the business only to the extent of their actual market values. The fact that they cost a greater amount would not benefit the business. . . . Business men and bankers, worthy of those names, would not have regarded it [the retained fund] as a surplus."<sup>109</sup> Unfortunately, this decision has not been followed, but has been minimized to a great extent by the opinion in *Helvering v. National Grocery Co.*,<sup>110</sup> wherein the United States Supreme Court sustained the imposition of a 102 penalty, despite a gigantic shrinkage in assets caused by the late depression, by holding that this was merely evidence which the Board and the Commissioner might consider in determining whether or not the accumulation exceeded the reasonable business needs.

The problem of shrinkage becomes even more acute when, due to depreciation of its assets, the company becomes insolvent and is prohibited by statute from declaring dividends. It would seem that under such circumstances a fail-

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<sup>108</sup> See *A. D. Saenger, Inc. v. Commissioner*, 84 F. 2d 23 (5th Cir.), *cert. denied*, 299 U. S. 577 (1936); *Suffolk Securities Corp.*, 41 B. T. A. 1161 (1940), *aff'd mem.*, 128 F. 2d 743 (2d Cir. 1942), *cert. denied*, 317 U. S. 700 (1943); *A. & J., Inc.*, 38 B. T. A. 1248 (1938); *Nipoch Corp.*, 36 B. T. A. 662 (1937); *Rands, Inc.*, 34 B. T. A. 1094 (1936), *appeal dismissed*, 101 F. 2d 1018 (6th Cir. 1939). But see *Commissioner v. W. S. Farish & Co.*, 104 F. 2d 833 (5th Cir.), *cert. denied*, 308 U. S. 559 (1939) (impairment of paid-in capital due to an operating deficit).

<sup>109</sup> *C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511, 517-518 (1938).

<sup>110</sup> 304 U. S. 282 (1938).

ure to declare dividends would be permissible. However, in one case the taxpayer was penalized for failure to declare dividends when to do so would have been a clear violation of a Texas statute. It was declared that, inasmuch as personal guaranties had been given by the principal stockholder, no one could have been harmed by a violation of that law.<sup>111</sup> In another case, the taxpayer was advised by its attorney and accountants that a payment of dividends would have been in violation of Section 58 of the New York Stock Corporation Law, prohibiting the payment of dividends impairing capital, and Section 664 of the New York Penal Law, providing that a director acquiescing in such payment is guilty of a misdemeanor.<sup>112</sup> Though the issue is outlined by the court in its statement of the facts, its failure to do more than mention it in the opinion is regrettable. When there is a statutory mandate against declaring dividends, compliance therewith assuredly should not result in the imposition of a 102 penalty and the courts should not be reluctant to so state.

#### H. *The Judgment of the Directors*

Whereas in stockholder suits, the judgment of the directors in not declaring dividends is normally accepted by the courts,<sup>113</sup> the rule is otherwise in Section 102

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<sup>111</sup> See *R. L. Blaffer & Co.*, 37 B. T. A. 851 (1938), *aff'd*, 103 F. 2d 487 (5th Cir.), *cert. denied*, 308 U. S. 576 (1939); see also *A. & J., Inc.*, 38 B. T. A. 1248 (1938).

<sup>112</sup> See *William C. Atwater & Co., Inc.*, 10 T. C. 218 (1948); see also *C. H. Spitzner & Son, Inc.*, 37 B. T. A. 511 (1938), wherein taxpayer was informed by its attorney that any distribution of dividends would impair capital, rendering the officers and directors liable civilly and criminally for their action.

<sup>113</sup> *New York, L. E. & W. R. R. v. Nickals*, 119 U. S. 296, 304 (1886). In *Williams v. Western Union Tel. Co.*, 93 N. Y. 162, 192 (1883), the court commented as follows: "When a corporation has a surplus, whether a dividend shall be made, and if made, how much it shall be, and when and where it shall be payable, rest in the fair and honest discretion of the directors uncontrollable by the courts." In 11 *FLETCHER CYC. PRIVATE CORP.* 808-811 (Rev. perm. ed. 1932) we find the following language: "The mere fact that a corporation has surplus profits out of which a dividend might lawfully be declared is not of itself sufficient ground for a court of equity to compel the directors to make a dividend, for they have a right to use surplus profits to extend the business of the corporation, or to make improvements, and even to provide a surplus fund, if it is to the interests of the corporation to do so, and a court of equity will not interfere with or control their discretion in determining what the interests of the corporation require in this respect, unless there is a clear abuse of discretion, or the action taken by the directors is unreasonable and oppressive.

cases.<sup>114</sup> In the *World Publishing* case previously referred to, the court stated as follows: "While the directors are entitled to exercise their judgment upon the question [of reasonable needs] . . . the determination is truly a judicial question . . . to be decided in the light of the circumstances and the applicable rules."<sup>115</sup> Again, in *Trico Products Corp., supra*, the Board reached the same conclusion in the following language: "We can not satisfy ourselves that our function would be performed merely by accepting the decision of petitioner's [taxpayer's] interested officers in the place of our independent judgment as to what was reasonably necessary to protect petitioner's future position."<sup>116</sup>

We see then that though the identical issue is involved, in non-tax cases the judgment of the directors in retaining earnings is accorded great weight, but that in 102 cases it is lightly regarded. The courts exercise their own judgment in tax cases, independent of that of the directors.<sup>117</sup> In the *World Publishing* case, where the taxpayer's presses were

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"The power of the directors is absolute if they act in the exercise of an honest judgment, and earnings of prosperous years may help out the deficiencies of other years."

<sup>114</sup> There are several notable exceptions to this statement. Thus in *R. C. Tway Coal Sales Co. v. United States*, 3 F. Supp. 668, 671 (W. D. Ky. 1933), *aff'd*, 75 F. 2d 336 (6th Cir. 1935), the following recognition is given the discretionary powers of directors: "Necessarily, the directors and officers of a corporation must be given, even in federal tax matters, some discretion and some latitude as to what constitutes the reasonable needs of the corporate business. It may well be doubted if the federal government, for the purpose of increasing its taxes, can absolutely destroy or arbitrarily limit this discretion resting in the directors of a corporation organized under state law." And in *Dill Mfg. Co.*, 39 B. T. A. 1023, 1031 (1939), there is this concession: "... we will hesitate before substituting our judgment upon the reasonableness of the corporate accumulations, for that of the directors."

<sup>115</sup> 72 F. Supp. 886, 894 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

<sup>116</sup> 46 B. T. A. 346, 375 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943).

<sup>117</sup> In dealing with a corporation whose business was trading in securities, the Board in *Rands, Inc.*, 34 B. T. A. 1094, 1103 (1936), *appeal dismissed*, 101 F. 2d 1018 (6th Cir. 1939), remarked: "The reasonable needs of the business are not to be regarded as controlled by the judgment of a stock trader, or even of a student of the market, as to the amount necessary to survive a sudden drop in the market or to take advantage of a rise." Along similar lines is the statement in *United Block Co. v. Helvering*, 9 P-H 1940 BTA MEM. DEC. ¶ 40,575 (1940), *aff'd*, 123 F. 2d 704 (2d Cir. 1941), *cert. denied*, 315 U. S. 812 (1942): "The question is not whether in the judgment of the officers the dividends declared were reasonable, but whether the accumulation of earnings was to any extent beyond the reasonable needs of the business."

operating at 50% of capacity but new equipment could not be purchased because of wartime conditions, the court held that the decision of the directors to retain a cash reserve for the purchase of the same was unreasonable on the ground, among others, that the company's prospects of earnings were good and should have been relied on for the necessary purchases. The court here clearly substituted its own judgment for that of men intimately acquainted with the business and who were responsible for its efficient operation. It is obvious that the discretion recognized in stockholder suits as belonging primarily to the directors has now been claimed by the courts when the Commissioner is the complainant. There is no real justification for this shift and it is but another illustration of the many oppressive innovations with which the tax litigant is compelled to cope.

We also find in the decisions such statements as: "directors may be more conservative than the statute permits"<sup>118</sup> (thereby incurring a 102 penalty) and "[t]he corporate exercise of judgment must succumb whenever it conflicts with the governmental policy as enacted by the Congress."<sup>119</sup> The statute hardly justifies such utterances, as there is no intimation found therein of a purpose to curtail a cautious exercise of discretion by a board of directors. So far as the provisions of the statute are concerned, a board may be as conservative as it pleases and still not be penalized. Of course, the frequently severe manner in which the section has been applied by the courts makes conservative policies extremely hazardous. Emphasizing tax acquisition rather than prevention of tax avoidance, the United States Supreme Court has stated that the purpose of Section 102 is "to compel the company to distribute any profits not needed for the conduct of its business. . . ."<sup>120</sup> In describing this as inconsistent with other statements in the same opinion, one writer correctly points out that "[t]his construction appears

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<sup>118</sup> *Trico Products Corp. v. McGowan*, 67 F. Supp. 311, 319 (W. D. N. Y. 1946), *aff'd*, 169 F. 2d 343 (2d Cir.), *cert. denied*, 335 U. S. 899 (1948).

<sup>119</sup> *World Pub. Co. v. United States*, 72 F. Supp. 886, 894 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

<sup>120</sup> *Helvering v. Chicago Stock Yards Co.*, 318 U. S. 693, 699 (1943).



to disregard purpose as a test of taxability,"<sup>121</sup> as indeed do the two quotations at the opening of this paragraph.

### I. *Subsequent Events*

Events subsequent to the withholding of funds have been of great aid to the courts in determining the reasonableness of corporate reserves.<sup>122</sup> Of course, "[s]ubsequent events are relevant only as they throw light on the period in question."<sup>123</sup> If it can be proven that the funds were in fact expended for the purpose for which they were allegedly retained, then the court will usually find for the taxpayer.<sup>124</sup> However, if the corporation cannot establish that the asserted plan was actualized, then, in the absence of a satisfactory explanation,<sup>125</sup> the Commissioner will be victorious.<sup>126</sup> But apparent fulfillment of a claimed intention does not always result in an exemption for the taxpayer. In the *World Publishing* case not only did the taxpayer in 1945 enter into a contract for the items which it could not obtain because of the war in 1942 and 1943 (the taxable years), but its reserves for the purchase of said items were substantially below their ultimate cost;<sup>127</sup> yet, the corporation was penalized under Section 102.<sup>128</sup> Also, in the *Trico Products* case the Board rejected an assertion that subsequent use of a retained fund was contemplated at the time the decision was made to withhold dividends.

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<sup>121</sup> Austin, *Section 102 and Capital Gains*, 26 TAXES 302, 305 (1948).

<sup>122</sup> *Trico Products Corp.*, 46 B. T. A. 346, 380 (1942), *aff'd*, 137 F. 2d 424 (2d Cir.), *cert. denied*, 320 U. S. 799 (1943): "... as bearing upon purpose, we may look to the history following" the taxable period in issue.

<sup>123</sup> *KOMA, Inc. v. Commissioner*, 189 F. 2d 390, 396 (10th Cir. 1951).

<sup>124</sup> See *Coca Cola Bottling Works v. United States*, 53 F. Supp. 992 (M. D. Tenn. 1944); *General Smelting Co.*, 4 T. C. 313 (1944).

<sup>125</sup> See *Wilkerson Daily Corp.*, 42 B. T. A. 1266 (1940), *aff'd*, 125 F. 2d 998 (9th Cir. 1942).

<sup>126</sup> See *United Block Co. v. Helvering*, 123 F. 2d 704 (2d Cir. 1941), *cert. denied*, 315 U. S. 812 (1942) (claimed contemplated purchase not made until two years later and under new management); *J. M. Perry & Co. v. Commissioner*, 120 F. 2d 123 (9th Cir. 1941) (claimed contemplated repairs never made).

<sup>127</sup> See *World Pub. Co. v. United States*, 169 F. 2d 186, 190, 191 (10th Cir. 1948) (dissenting opinion), *cert. denied*, 335 U. S. 911 (1949).

<sup>128</sup> In *Whitney Chain & Mfg. Co.*, 3 T. C. 1109 (1944), *aff'd*, 149 F. 2d 936 (2d Cir. 1945), a retention of \$70,000 for an anticipated expansion caused by the war was held to be unreasonable, despite the fact that approximately \$582,000 was ultimately expended.

### J. *Efficacy of Appeal*

Once the Tax Court has determined Section 102 to be applicable, the chances of a reversal by the Court of Appeals are negligible,<sup>129</sup> because a finding that the taxpayer was formed or availed of for the prohibited purpose involves a question of fact which, if supported by substantial evidence, is binding on the latter court.<sup>130</sup> In *Gibbs & Co., Inc. v. Commissioner, supra*, it was stated as follows: "The scope of judicial review in a case of this character [*i.e.*, involving Section 102] is extremely limited . . . . The inferences which the Tax Court has drawn from the undisputed primary facts cannot be upset, unless arbitrary, merely because in the exercise of an independent judgment we might draw different inferences as to the reasonable needs"<sup>131</sup> of the taxpayer's business.

Even where the government called no witnesses and the taxpayer's evidence was not contradicted, an appeal by the taxpayer was ultimately to no avail.<sup>132</sup>

### III. PROBLEMS CREATED BY SECTION 102

Even a cursory analysis of Section 102 cases reveals that a considerable number of them are inconsistent, while others are irreconcilable. However, one conclusion is inescapable: an accumulation beyond the ordinary by a closely held corporation is extremely perilous under almost any circumstances.

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<sup>129</sup> In *Dobson v. Commissioner*, 320 U. S. 489 (1943), the rule was laid down that a finding of fact by the Tax Court if supported by the record is not subject to appellate review. However, this rule was practically obliterated in 1948 when INT. REV. CODE § 1141(a) was amended so as to make the Tax Court subject to the same type of review to which district courts are subject, *i.e.*, findings of fact as well as findings of law may be scrutinized. With the departure of the *Dobson* rule, the opinion was expressed that reversals of Tax Court rulings in § 102 cases would become more frequent. *LASSER & HOLZMAN, CORPORATE ACCUMULATIONS AND SECTION 102* 153 (1949). However, such has not been the case thus far.

<sup>130</sup> Cf. *Helvering v. National Grocery Co.*, 304 U. S. 282 (1938); *Olin Corp. v. Commissioner*, 128 F. 2d 185 (7th Cir. 1942); *Commissioner v. Cecil B. DeMille Productions, Inc.*, 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937).

<sup>131</sup> 147 F. 2d 60, 63 (2d Cir. 1945).

<sup>132</sup> See *National Grocery Co. v. Helvering*, 92 F. 2d 931 (3d Cir. 1937), *rev'd*, 304 U. S. 282 (1938).

Some tax experts feel that, on the whole, the courts have been rather tolerant of the taxpayer in 102 cases.<sup>133</sup> Regardless of whether or not this conclusion is warranted,<sup>134</sup> such cases as *World Publishing Company v. United States* completely dispel any reassurance that might otherwise be forthcoming from the decisions. The Bureau of Internal Revenue itself has repeatedly insisted that the statute will be interpreted and applied fairly,<sup>135</sup> and a few writers are of the opinion that it actually has shown more than customary leniency.<sup>136</sup> Nevertheless, on every corporation return filed, the Bureau now requires its agents to make a specific finding as to the applicability of Section 102 and special attention is to be given to any corporation which has failed to distribute more than 70% of its excess earnings in the taxable year.<sup>137</sup> In any event, the general consensus of those in the tax field seems to be that strict enforcement of the statute is sought.<sup>138</sup>

However, the major evil of the statute is not the tax consequences that have thus far been incurred, though certainly they have been disastrous enough for some companies, but

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<sup>133</sup> See Cary, *Section 102 May Not Be the Menace Some Tax Men Consider It To Be*, 89 J. ACCOUNTANCY 219, 220 (1950); Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)*, 60 HARV. L. REV. 1282, 1297 (1947).

<sup>134</sup> There have been only a little more than 100 reported cases dealing with § 102 and its predecessors, approximately half of which have been in favor of the Commissioner and half in favor of the taxpayer. "This seeming lack of judicial attention attracted by the Section . . . deceives no well-informed corporate director as to its importance." Buck & Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 323 (1950) (second of three published parts). This article contains an exceptionally fine statistical compilation of § 102 cases.

<sup>135</sup> KNAPP & WARREN, *FORMS OF BUSINESS ORGANIZATION AND THE FEDERAL TAX LAWS* 23 (Rev. ed. 1951).

<sup>136</sup> See Miller, *Bureau Policy on Section 102*, 6 N. Y. U. ANN. INST. FED. TAX. 975 (1948), wherein it is pointed out that an average of less than 100 deficiency notices a year under § 102 were issued for the period from 1939 to 1947.

<sup>137</sup> T. D. 4914, 1939-2 CUM. BULL. 108, amended by T. D. 5398, 1944 CUM. BULL. 194. The adoption of such policies were considered to be an indication that § 102 would be more vigorously enforced (Bock, *Tax Problems of Small Business*, 25 TAXES 142, 144 (1947)) and that a "get tough" policy would be exercised (Buck & Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 141, 182 (1950) [the first of three published parts]).

<sup>138</sup> See 2 CCH 1952 FED. TAX REP. ¶ 677.023.

rather it is the "powerful silent pressure" <sup>139</sup> exerted by the statute on small corporations compelling them to declare dividends against wiser business judgment.<sup>140</sup> The Bureau has followed no consistent policy <sup>141</sup> and it is impossible to foresee what test or line of attack will be employed by it.<sup>142</sup> Nor do the decisions reveal any safe guide for the boards of directors.<sup>143</sup> With the potentiality of the statute thus unlimited, many directors are unwilling to gamble on how the authorities will view a decision to retain earnings and are thus coerced into a distribution of dividends.<sup>144</sup>

For those directors who have made an honest decision to withhold dividends, it is certainly frustrating to have a visitation from a revenue agent who, having no familiarity with, nor responsibility in the business, and with the benefit of hindsight, will decide whether or not their action was reasonable.<sup>145</sup> Obviously, it is both "absurd and unjust" <sup>146</sup> that a disinterested agent should be free to make a decision of this type. Revenue officers are not selected for the purpose of passing upon the financial needs of a corporation and have not the background or experience to do so.<sup>147</sup> It may be added that the courts are likewise usually ill-equipped to make a dogmatic pronouncement concerning what are or are not the reasonable needs of a business. Until the judgment of the directors is elevated from the position of inferiority

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<sup>139</sup> Lowrimore, *The Penalty Surtax under Section 102*, 29 TAXES 215, 219 (1951), quoting from the report of the Committee on Federal Taxation of the American Institute of Accountants submitted to the Eighty-first Congress in April, 1950.

<sup>140</sup> *Ibid.* See also Holzman, *Impact of the War's End on Section 102*, 24 TAXES 24, 28 (1946), in which it is reported that a poll of corporations (*Effects of Taxes Upon Corporate Policy*, National Industrial Conference Board) indicated that because of § 102 many of them "felt obliged to make larger distributions than prudence dictated . . ." and considered the statute "a direct deterrent to productive activity."

<sup>141</sup> See Miller, *supra* note 136, at 976.

<sup>142</sup> See Cary, *Section 102 May Not Be the Menace Some Tax Men Consider It To Be*, 89 J. ACCOUNTANCY 219 (1950).

<sup>143</sup> "Section 102 is a strange branch of tax law. The courts can clarify little in it that will have wide application to other cases." Landman, *Concepts of Section 102*, 26 TAXES 19, 26 (1948).

<sup>144</sup> See Turner, *Unreasonable Accumulation of Surplus . . . Section 102*, 26 TAXES 839, 843 (1948).

<sup>145</sup> See Lowrimore, *supra* note 139, at 219.

<sup>146</sup> Turner, *supra* note 144, at 843.

<sup>147</sup> See Ballantine, *Psychological Bases for Tax Liability*, 27 HARV. BUS. REV. 200, 205 (1949).

which it now occupies in the eyes of the authorities, it may be expected that enforcement of 102 will continue to be erratic and unpredictable.

Since an unfavorable reaction by the Commissioner is not likely to be manifested until more than two years after the taxable year, and a court decision upholding that reaction may require an additional two years thereafter, the danger under the statute is greater than appears at first glance. If it is ultimately determined that funds were unreasonably retained, then an unsuspecting continuance of that policy during the intervening years is almost certain to meet the same fate. Of course, if a corporation distributes all its current year's earnings there can be no penalty despite the fact that its surplus, built up by prior years' earnings, is more than adequate for its needs.

All of the decided cases have apparently dealt with corporations controlled either by a sole stockholder or by a small group of stockholders. In *Trico Products Corp. v. Commissioner*, *supra*, there were approximately 2,200 stockholders involved, but a group of six owned almost 74% of the stock. Some writers have opined that with the advent of this case the government would seek to penalize corporations that were even more widely held.<sup>148</sup> However, thus far the contention that "except in the rarest instance the section obviously has application only to close corporations"<sup>149</sup> would seem to be a sound one. The difficulty in endeavoring to prove tax avoidance where the corporation is publicly held is evident. That small corporations are thus necessarily the target of Section 102 is unfortunate. For one thing, it is very difficult for small companies, particularly those in the growing stage, to obtain outside capital<sup>150</sup> and often they are forced to retain earnings in order to survive. Statistics show that "profitable small firms on the average pay out a smaller percentage of income as dividends and earn a higher rate of profit on net worth than do large corporations, and that their retained earnings normally consti-

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<sup>148</sup> See Turner, *supra* note 144, at 843.

<sup>149</sup> Barrett, *The Section 102 Penalty*, 24 TAXES 656 (1946).

<sup>150</sup> See Bock, *supra* note 137, at 144.

tute a much larger percentage of their net worth and of total assets.”<sup>151</sup> As a matter of fact, so far as small corporations are concerned, the Treasury Department’s own statistics contradict its rule-of-thumb requirement that a 70% annual distribution be made.<sup>152</sup> Small companies have been the backbone of the industrial progress of America and, with their opportunity to grow stifled as it is by Section 102, our economic well-being is seriously threatened. The point has been well made that the government, by forcing corporations under the threat of Section 102 to distribute dividends, will in the end be a co-loser with the corporation, in that taxable revenue resulting from capital advantageously used will not be forthcoming.<sup>153</sup>

An additional hazard to directors is the possibility that because of the imposition of a 102 penalty they might be amenable to a stockholder suit based on claimed negligence in not declaring dividends in the taxable years. The directors involved in the *Trico Products* case were sued by minority stockholders on this basis and the suit was finally settled for \$2,390,000 on the understanding that dividends in excess of \$3,300,000 would forthwith be paid by the company, this in addition to the fact that approximately \$10,000,000 had been collected in 102 penalties.<sup>154</sup> Logically, it might be said that if the Tax Court has determined that the directors of a corporation were unreasonable in accumulating earnings and that they had as their purpose the avoidance of personal income taxes, then said findings should ipso facto insure the success of a stockholder suit. If the Tax Court has decided

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<sup>151</sup> Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)*, 60 HARV. L. REV. 1282, 1294-1295 (1947). See also Goodman, *Section 102—A Postwar Tax Problem*, 81 J. ACCOUNTANCY 200, 201 (1946).

<sup>152</sup> Landman, *supra* note 143, at 21.

<sup>153</sup> See Holzman, *What's New in 102?*, 25 TAXES 101, 110 (1947). Note also the statement of the plaintiff in *Trico Products Corp. v. McGowan*, 67 F. Supp. 311, 325 (W. D. N. Y. 1946), *aff'd*, 169 F. 2d 343 (2d Cir.), *cert. denied*, 335 U. S. 899 (1948): “. . . the Revenue Department is engaged in a short-sighted attempt to kill the goose that lays the golden eggs. The Government is involved in a cause which, were it to succeed, would lose for the Government many times over the amount of the penalties which it seeks to enforce.”

<sup>154</sup> See Lasser & Holzman, *Personal Liability of Directors for Section 102 Surtaxes*, 16 CONTROLLER 342 (1948).

that the directors were unreasonable, what could intervene in a stockholder litigation to change this designation of their conduct? Fortunately, the unfairness of Section 102 would probably not be transported to a stockholder suit. For one thing, the Commissioner in 102 cases has the benefit not only of presumptions not available to the plaintiff minority stockholder, but also the powerful "reasonable needs" provision of the statute. Of course, presumptions and like mechanisms of the law are simply supposed to supply assistance in the quest for truth, but in tax cases they often have the reverse effect. Recognizing that the directors have these technical obstacles to contend with, the court in a stockholder suit would undoubtedly seek to make a determination of its own as to the reasonableness of the directors' conduct.<sup>155</sup> Of course, the danger of a stockholder suit should not be minimized. As a matter of fact, the opinion has been expressed that in such a suit the directors would be even more vulnerable than in an ordinary stockholder suit, inasmuch as the element of personal gain (in the form of income tax savings) would be present, as is not usually the case in stockholder suits for mismanagement.<sup>156</sup>

#### IV. RECOMMENDATIONS

Motivated mainly by the reported decisions, there have been many articles written suggesting precautions to be taken in order to avoid the Section 102 penalty, some of which may be stated as follows:

- (1) Record in minutes of meeting or other permanent form any proposed plan of expenditure;
- (2) If equipment is to be purchased later, place an order for it now as evidence of the intention;
- (3) Directors should keep a record of why they do not declare dividends;
- (4) A cash forecast should be prepared in advance of the dividend meetings;

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<sup>155</sup> See Note, *Derivative Actions Arising from Payment of Penalty Taxes under Section 102*, 49 COL. L. REV. 394 (1949).

<sup>156</sup> See Lasser & Holzman, *supra* note 154, at 344.

- (5) No loans should be made to stockholders or members of their families or to enterprises in which they are interested;
- (6) Do not invest in securities unrelated to the business;<sup>157</sup>
- (7) An economist should be employed to guide the directors in their appraisal of business conditions;<sup>158</sup>
- (8) Any member of the board who would profit from a retention of funds should resign;
- (9) The dividend ratio of the taxpayer's industry should be ascertained and considered;<sup>159</sup>
- (10) When incorporating a business, deliberately undercapitalize the corporation;<sup>160</sup> and
- (11) Pay out some dividends rather than none at all.<sup>161</sup>

In addition, one writer has made a comprehensive compilation of the data and type of evidence that would be useful in establishing the reasonableness of an accumulation.<sup>162</sup> Suggested remedies have also been offered to those corporations which either must distribute dividends or clearly run the risk of a 102 penalty.<sup>163</sup>

Ever since 1938, when a vigorous assault on the statute's constitutionality was successfully resisted in the Supreme Court of the United States,<sup>164</sup> innumerable proposals have been made that 102 be amended or that other steps be taken

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<sup>157</sup> Suggestions (1) to (6) may be found in Holzman, *Impact of the War's End on Section 102*, 24 TAXES 24, 32 (1946).

<sup>158</sup> See Simons, *Modern Techniques in the Practice of Tax Law*, 24 TAXES 330, 337 (1946).

<sup>159</sup> Suggestions (8) and (9) are contained in Holzman, *What's New in 102?*, 25 TAXES 101, 108-109 (1947).

<sup>160</sup> See *Partnership or Corporation*, 86 RESEARCH INST. AMER. ANALYSIS 12 (Dec. 1951).

<sup>161</sup> See Cary, *Section 102 May Not Be the Menace Some Tax Men Consider It To Be*, 89 J. ACCOUNTANCY 219, 223 (1950).

<sup>162</sup> See Lowrimore, *supra* note 139.

<sup>163</sup> See Finkelstein, *The Case of the Undistributed Earned Surplus*, 24 ST. JOHN'S L. REV. 221 (1950).

<sup>164</sup> See *Helvering v. National Grocery Co.*, 304 U. S. 282 (1938).



to lessen its effect.<sup>165</sup> Not all sentiment, however, has been running in this vein.<sup>166</sup>

Among the many proposed amendments and other recommendations, some of the more noteworthy are the following:

- (1) Stockholders should report as taxable income their pro rata share of annual taxable corporate earnings in lieu of reporting dividends received, the corporation making advance tax payments for the account of the stockholders;<sup>167</sup>
- (2) "At the taxpayer's option, dividends paid after the end of the taxable year but before the due date (original or extended filing date) of the tax return should be allowed as a credit in computing undistributed Section 102 net income";
- (3) In the event of 102 tax, "the corporation should be permitted to relieve itself of such tax, in whole or in part, by a deficiency dividend . . . or . . . by filing consent dividends";
- (4) ". . . [C]lear statements of fact should support a determination of a proposed assessment of the penalty surtax," and only clearly flagrant violations should be penalized, the taxpayer getting the benefit of any doubt;<sup>168</sup>
- (5) The burden of proof should be on the Commissioner;
- (6) Instead of levying the tax on the entire amount withheld, as is now the case, only that part which has been unreasonably withheld should be taxable;

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<sup>165</sup> See, e.g., Barrett, *supra* note 149, at 658: ". . . [S]uch speculative intricacies of law and corporate management as are involved in Section 102 have no place on principle in a fair and realistic revenue system. . . ."

<sup>166</sup> For a summary of the views pro and con on the merits of § 102 consult Holzman, *Impact of the War's End on Section 102*, 24 TAXES 24, 31 (1946). See also Landman, *supra* note 143, at 29 wherein it is reported that the AFL was against any amendment of § 102 and that the CIO proposed that after the payment of dividends a 19% tax be levied on all retained funds above \$25,000.

<sup>167</sup> See Westfall, *Integrating Federal Income Taxes on Corporations and Their Shareholders*, 27 TAXES 236, 240 (1949).

<sup>168</sup> For recommendations (2) to (4) see Lowrimore, *supra* note 139, at 219.

- (7) Double taxation of dividends should be eliminated;<sup>169</sup>
- (8) A corporation should be permitted to accumulate a certain amount as a cushion for a bad year;
- (9) When a corporation submits requested information as to its financial needs, the burden of proof should be on the Commissioner;
- (10) Publicly held corporations should be exempt from the statute;<sup>170</sup>
- (11) Small companies should be taxed as partnerships;<sup>171</sup> and
- (12) The first \$25,000 of retained profits should be exempted from the penalty, this amount to be increased progressively according to sales, profits, etc.<sup>172</sup>

More than a few authorities have been of the opinion that mere amendment will not remedy the evils of Section 102 and that total repeal alone is the solution.<sup>173</sup> The writer does not believe that it is wise to go this far. Undoubtedly there are those whose purpose it is to save taxes through corporate accumulations and a sound policy of revenue collection requires some restriction on such aims. "The ideal is to penalize the chiseler without injury to the innocent."<sup>174</sup> It would seem that this ideal is impossible of attainment and that a maximum detection of tax evasion can be achieved only at the expense of a retarded development of business. The question is whether first consideration should be given to the limiting of restrictions on the growth of business or to the apprehending of as many tax dodgers as possible.

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<sup>169</sup> See Turner, *supra* note 144, wherein it is stated at 845-846 that proposals (5) and (6) have been submitted to Congress.

<sup>170</sup> Recommendations (8) to (10) are set forth in Buck & Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 VA. L. REV. 461 (1950) (last of three published parts).

<sup>171</sup> Randolph E. Paul, mentioned in Bock, *supra* note 137, at 142.

<sup>172</sup> See Landman, *supra* note 143, at 28.

<sup>173</sup> "Section 102 requires cure . . . by using the axe." Ballantine, *supra* note 147, at 205.

<sup>174</sup> Buck & Shackelford, *supra* note 170, at 142 (first of three published parts).

Section 102 gives preference to the latter alternative. It is difficult to agree with those who maintain that the significance of Section 102 has been overemphasized and that businessmen have been needlessly conservative because of pessimistic advice given them.<sup>175</sup> Rather, the writer feels that the section is "fraught with pitfalls"<sup>176</sup> and that to avoid ruinous penalties "constant alertness"<sup>177</sup> is mandatory. When it is considered that corporations are already harassed by a burdensome excess profits tax,<sup>178</sup> the belief becomes strong that the section is unnecessarily detrimental to the industrial progress of the country.<sup>179</sup> The amount gained in revenue does not come close to balancing the harm done.<sup>180</sup> Our economic prosperity should not be threatened just for the sake of ensnaring a few tax evaders. However, the situation may be righted without total annihilation of 102. It would seem that most, if not all, of the devastating uncertainty produced by Section 102 could be eradicated by deleting from its provisions any reference to "reasonable needs" and by placing the burden of proof squarely on the Commissioner.<sup>181</sup> Presumably the "reasonable needs" provision was inserted in 102 as an aid in ascertaining whether the prohibited purpose to avoid taxes was present. However, in view of the manner in which the statute has been interpreted and enforced, the "aid" has now become an end in itself and little endeavor is exerted in determining the actual

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<sup>175</sup> See Cary, *Section 102 May Not Be the Menace Some Tax Men Consider It To Be*, 89 J. ACCOUNTANCY 219 (1950): "Section 102 has been so widely feared and vilified that most businessmen probably take it too seriously." Of a similar view is Miller, *supra* note 136. In Barrett, *supra* note 149, at 656 it is stated that "the bark of 102 is considerably worse than its bite." However, the reasoning of the author seems to be limited mainly to pointing out that if the shareholder's tax bracket is high enough it is preferable, from a standpoint of immediate tax consequences, to have the corporation suffer the 102 penalty, a conclusion compelled by simple mathematics. If the stockholder's bracket is low enough the "bite" is apt to approach rapacious proportions.

<sup>176</sup> Goodman, *supra* note 151, at 200.

<sup>177</sup> Simons, *supra* note 158, at 331.

<sup>178</sup> See INT. REV. CODE § 430 *et seq.*

<sup>179</sup> See Buck & Shackelford, *supra* note 170, at 473 (last of three published parts).

<sup>180</sup> "... [T]here may be abuses of the corporate option; but a statute as unrealistic and discriminatory as Section 102 tends to cure the ailment by killing the patient." Turner, *supra* note 144, at 843.

<sup>181</sup> At present the taxpayer frequently must prove a negative, *i.e.*, that it had no unlawful intent, "always a difficult task." Turner, *supra* note 144, at 843.

intent of the directors. Rather, the Commissioner concentrates all his effort in establishing an unreasonable accumulation and that being done, victory is almost certain to follow.<sup>182</sup> As one writer has indicated, what constitutes reasonable or unreasonable needs cannot be determined objectively, and there may be disagreement among the management itself, no mind between the management and the Internal Revenue Bureau.<sup>183</sup> So nebulous and fleeting a concept should not be the basis of a severe penalty tax.

Concededly, the suggested statutory revision would make the Commissioner's job not an easy one. However, clear-cut cases of tax evasion would pose no serious problem and cases that in the past have been decided more or less by guesswork would be non-existent.

Section 102 as presently constituted manifestly is in need of drastic revision and it is hoped that Congress will not be long in coming forth with an improved version thereof.<sup>184</sup>

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<sup>182</sup> "In practice, application of the tax is made to depend on whether the retention of earnings or profits seems to be warranted by 'the reasonable needs of the business.' No reliance either way seems to be placed upon establishing the actual mental attitude of directors or stockholders. Virtually complete reliance is placed upon the statutory presumption . . . ." Ballantine, *supra* note 147, at 204.

<sup>183</sup> *Ibid.*

<sup>184</sup> Of considerable merit is the suggestion of the American Institute of Accountants that a non-partisan tax commission be established to suggest to Congress a complete overhauling of existing federal tax laws. See Bock, *supra* note 137, at 161.